

Column: Hedge funds slash oil positions amid extreme volatility



By John Kemp

LONDON, March 14 (Reuters) – Investors cut bullish bets on oil last week as prices surged to multi-year highs, the economic outlook deteriorated, and extreme volatility made derivatives positions more expensive to maintain.

Hedge funds and other money managers sold the equivalent of 142 million barrels in the six most important petroleum-related futures and options contracts in the week to March 8.

Last week's sales were the 11th largest out of 469 weeks since March 2013, records published by ICE Futures Europe and the U.S. Commodity Futures Trading Commission showed.

Portfolio managers sold Brent (-97 million barrels), European gas oil (-23 million), U.S. gasoline (-13 million) and U.S. diesel (-11 million) and were buyers only of NYMEX and ICE WTI (+2 million).

The selling was dominated by closure of existing bullish long positions (-114 million barrels) rather than the initiation of new bearish short ones (+28 million), consistent with a risk-reducing strategy.

Funds ended up with a net position in the six contracts of just 588 million barrels (45th percentile for all weeks since 2013) down from a peak of 761 million barrels (70th percentile) on Jan. 18.

Bullish long positions outnumbered bearish short ones by a ratio of 4.76:1 (61st percentile) down from 6.24 (80th percentile) in mid-January (Link).

In recent weeks, the record backwardation in futures prices, accelerating rise in spot prices, and increasing day-to-day volatility have been signs of a market under extreme stress and likely to reverse course.

Soaring oil prices have been part of a broader increase in the price of raw materials, manufactured items and freight charges which has raised the probability of a recession within the next 12 months.

Reflecting the deteriorating economic outlook and volatility costs, distillate positions were cut to 85 million barrels (67th percentile) last week down from a recent peak of 144 million barrels (85th percentile) five weeks earlier.

Rising volatility is also a symptom of a market becoming less liquid, with both bullish and bearish investors less willing to take on new risk exposures and instead reducing positions until trading becomes calmer.

Heightened volatility has fed through into more demands for margin from brokers and clearing houses and makes futures and options positions increasingly expensive to maintain, encouraging fund managers to trim positions.

Extreme volatility and rapidly diminishing liquidity is reminiscent of trading conditions in the second quarter of 2008 as oil prices climbed towards a record high in the first half of July before plunging.

Oil prices are caught between rising supply risks as a result of Russia's invasion of Ukraine and the consequent sanctions on the country's output, and growing demand risks stemming from inflation and a possible recession.

In this increasingly unstable and chaotic situation, many hedge fund managers have decided it is prudent to realise profits from previous long positions and reduce risk exposure until the balance of risks becomes clearer.

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